RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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**June 24, 1992** **LETTER 1098**

**THE MARKET:** Up to now we could have called this the "stealth market," stealth as in stealthy or sneaky erosion. How so? Well, I've been using the Mutual Fund Index (courtesy of *Investor's Business Daily)* as a proxy for the average investor's stock portfolio. As of June 19, this index of 20 leading mutual funds was down a costly 11.3%.

If there's any doubt about the erosion, just study the path of the advance-decline ratio shown on the page 2 chart. This index traces the advancing or declining action of the majority of stocks on the NYSE. It's not a pretty picture.

As further evidence, Bob Farrell of Merrill Lynch reports that a shocking 40% of ALL stocks have been down 30% so far this year (figuring from the first quarter 1992 to the second quarter 1992).

But here's the amazing part -- all this occurred with the Dow within a few percentage points of its all-time high (shades of 1972?). The broader averages such as the S&P 500 and the NYSE Composite topped out back on January 15, more than five months ago. But the stronger Dow has served to keep the average stockholder holding and hoping.

Question: What would constitute a true Dow Theory bear signal? Answer: a violation of the April 8 lows by both D-J Averages, and I stress that it must be BOTH Averages. The April lows were **3181.35** for the Dow, **1301.57** for the Transports. Keep those numbers in mind -- they are critical (amazing: have you noticed that nobody has mentioned the bear signal points?).

What about values? *Barron's* lists the price/earnings ratio for the Dow at a ridiculously high 65. This includes ten Dow stocks with negative earnings over the last four quarters, and on that basis some bulls are complaining that the 65 P/E is deceptive. Maybe, but on the next page I have included *Ned Davis Research's* chart of the price/earnings ratio for the very broad S&P 500 Stock Index. Here we see the P/E ratio for the S&P at 25, which happens to put it at the highest level since World War II.

Of course, overvaluation alone can never pin-point the exact top for the stock market, but it does tell us that we've been looking at one of the most expensive markets in history. And when bull markets become expensive they tend to be followed by costly bear markets.

In Letter after Letter I've pointed to all the problems: the discrepancies, the divergences between the Dow and the A-D ratio, the lagging composite averages, the dramatic drop-off in daily new highs, the decline in volume, the sudden swooning of favorite stocks.

All of which has given us costly erosion but no definite signal yet for a primary bear market. So what do we do? *The very basis of Dow Theory is the buying of stocks when they represent great values and the selling of stocks when those shares become vastly overvalued.* So if you follow the precepts of Dow Theory (which I do), you're just about out of equities.

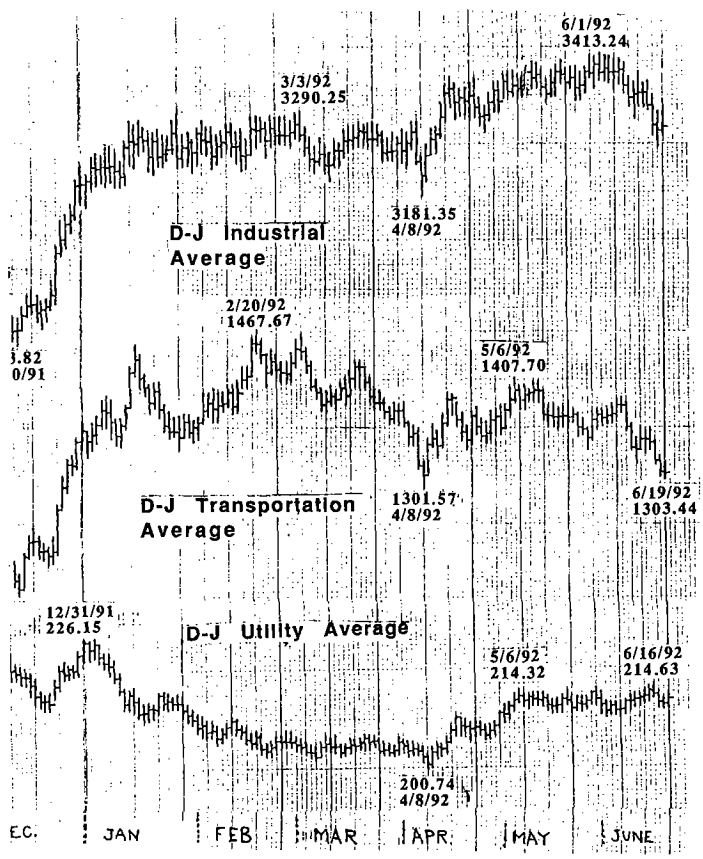
What about my Primary Trend Index (PTI)? One of the advantages of the PTI is that it can cut through the smog of a confusing market -- and render a very simple but crucial verdict. The PTI has formed a double top -- 3510 on June 8, and 3509 on June 15, and then turned down (see page 2 chart). But so far, the PTI has not broken below its 89-day moving average (MA).

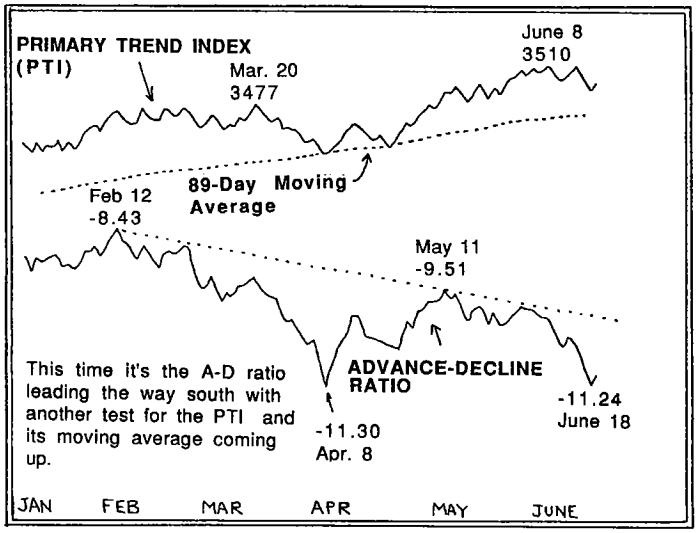
**June 12 DJIA 3354.39; PTI 3508; A-D Ratio -10.38**
**June 19 DJIA 3285.38; PTI 3497; A-D Ratio -11.10**
**Dow Yield: 3.14%; Dow Price/Earnings: 68.3**
**Dow 200-day MA: 3166; Dow 30-day MA: 3385**
**Dow Times Book Value: 2.46; PTI 89-day MA: 3474**
**Percentage of Undervalued Blue-chips: 9%**

In December and again in April-May the PTI turned down and touched its MA, following which the PTI rallied to new highs. If it turns out this time that we are in a true bear market, the PTI will act differently. It will break below its MA and continue down for months on end. BUT -- it hasn't done that yet.

**Conclusion:** The signs of danger are there for all to see -- the divergences, the non-confirmations, the weaknesses in world markets, the renewed crash of the Tokyo stock market, the sudden collapse of the Mexican stock market. But as far as the US situation is concerned, we still have no proof of a bear market yet. That doesn't mean, however, that we have to hold stocks.

**DEAD:** Why did the House kill the balanced-budget amendment? Answer: Too many House members didn't want their personal spending plans to be curtailed. That figures. But it was the deceit, the damnable lies, that were so hard to stomach. House Majority Leader Gephardt had the unmitigated gall to announce that the vote was "a victory for controlling the deficit." Jack Brooks (D-Texas) said, "This amendment is an outrageous and dangerous abdication of our responsibilities as elected officials." What utter rot -- the House has abdicated its responsibilities for years. Budget Committee Chairman Pannetta said, "Leadership cannot be found in any Constitutional amendment." Right, but the amendment






would have been law, a law to take the place of the missing leadership -- the bitter fact is that the House hasn't shown any leadership on the deficit for the past 20 years. Final result? Look for little or no action on the budget until after the election. After the election? Look for debates, stalls, and again -- little or no meaningful action (except, maybe a national sales tax). My prediction: the finances of the US government will continue to be totally out-of-control.

**THE PICTURE:** No matter who captures the presidency, the winner will have to face one item -- the budget. When you talk about the US budget, you're talking about ENTITLEMENTS. This is the monster that Congress created. Thirty years ago entitlements comprised roughly one-tenth of the federal budget. Today entitlements take up half of the budget -- the annual entitlement bill is $700 billion. But wait, there's another quasi-entitlement area, and it's the tax breaks the government gives for health care, housing, employment and retirement. The tax breaks amount to almost $300 billion. So the whole entitlement package adds up to roughly **$1 trillion a year.**

Over the last twenty years the US economy has grown at the rate of 2.7% a year. Over the same period entitlement expenses have grown at the rate of 6% a year. Result -- entitlements are now eating this nation up alive. To the entitlement package, add the huge and wasteful military budget, which is $270 billion, and add interest on the federal debt, which will be pushing $300 billion. So there you have it -- all the elements needed for an economic disaster.

It boils down to this -- something's got to give. So far, what's given is the balance-sheet of the US government -- and the dollar. What happens next? Some wag suggested, "Maybe the government should just declare bankruptcy." But, of course, that'll never happen, because if the government declared bankruptcy, it s credit would go down the drain, and if the government's credit is kaput, it can't borrow. And the government must borrow to survive.

The fact is that we've been on a wild borrowing party for decades (you may find that hard to believe that if you visit any large American city), and we've borrowed trillions of dollars to keep the party going. But ultimately, every party ends. And when that happens the participants have to pay the bills and take the pain.

The pain has already surfaced here in '92 as budgets are squeezed and as states, cities and counties cut back because they just don't have the money. Business has also cut back, mostly for the sake of efficiency and boosting profits. The result -- a national unemployment rate of 7.5% (it's 8.7% in California).

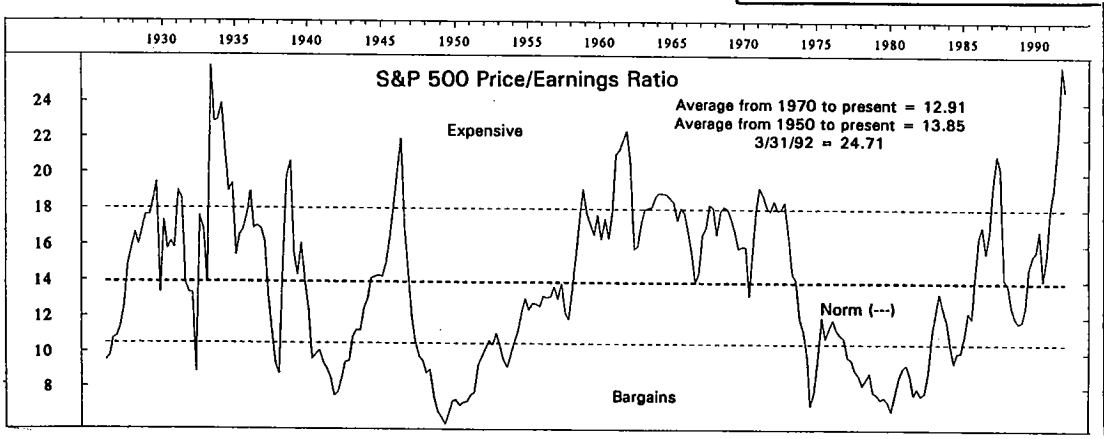
Unfortunately, that's just the beginning. The real pain won't begin until the next primary bear market starts. A few years ago I stated that "when the recession begins the Fed will fight it tooth and nail." And that's exactly what's been happening. But the fighting has been limited to pushing down short-term interest rates. For the first time since World War II the government has not had the wherewithal to spend us out of a recession. With $450 billion being added to the national debt over the last 12 months, Washington has been afraid of spending us out of this recession. Besides, if current deficit spending of $1.2 BILLION A DAY can't produce prosperity, you have to wonder how much deficit spending it would take to bring back the good times.

So that's the situation we find ourselves in today. The nation is in a deficit-crunch, and the only thing standing between us and an all-out crisis is the fact that the world is still accepting dollars as a medium of exchange (but no longer as a store of value). That, to me, is one of the keys to investing today -- the coming acceptability (or non-acceptability) of the world's reserve currency -- the dollar (see Investment Position box in this Letter).

Note: Ross Perot says that if he's president he's going to balance the budget by cutting out the waste and eliminate paying Social Security to "the rich." Yeah, OK, but these measures won't solve the entitlement problem, they're just drops in the bucket. And as an aside, wasn't Social Security supposed to be a saving program with everyone contributing and everyone getting his fair return at age 65? If we eliminate SS benefits for selected people, despite the fact that they contributed to SS all their lives, it renders SS just another tax program based on a reshuffling of assets. Of course, that's not what they told me it was thirty years ago (now do you see why Congress exempted itself from the whole Social Security program?).

**INVESTMENT POSITION:** M.O.T.S. That stands for "more of the same." A shaky and smaller bull is in the box, the market action continues poor, the divergences continue, and if you're still loaded with "sound equities," you're probably not too happy. As subscribers know, I've been advocating basically a position on the sidelines.

"Being on the sidelines" used to mean "being safe" in a money market fund or in T-bills or even in CDs. But today, there's really no such thing as "being safe." With US debt building and compounding into an absolute financial monster, the dollar is no longer a safe haven. Let's be honest, in today's super-difficult markets what we want to do is "not lose money" or at least not lose purchasing power. I believe that this entails intelligent diversification.



Unfortunately -- the way things are going I'm not very hopeful about the dollar. This means (at least for me) some diversification out of dollar-denominated items. You can accomplish this a number of ways, but one way I favor is with an international government bond fund. Why pick that route? A number of reasons. (1) World stock markets are sliding, world business is slowing down, world unemployment is rising, and if this continues there will be pressure on the world's central banks to bring interest rates down. In other words, I think international rates are high, considering the trend of world business.

# Unemployment Rising Over Much of Globe

*Slow economic growth worldwide indicates little creation of new jobs, layoffs for many*

By Amy Kaslow
Staff writer of The Christian Science Monitor
WASHINGTON

since 1984. But at 7.5 percent, it still falls well below most European countries, which together average an annual rate of 8 to 9 percent.

The stronger safety nets in France and Britain, for example,

(2) Governments seldom default on their bonds, which means that government bond principal can be considered very safe. (3) Germany sets the trend of rates in Europe, and Germany will fight inflation tooth and nail, even to the point of accepting a recession. But business is slowing down in Germany, unemployment is up, and I would guess that even German rates might come down before the year is out.

(3) If German rates come down, the rest of the European rates will follow, which would obviously be bullish for European bonds.

So here are the main items in favor of European government bonds -- a weak dollar, high European money rates that could come down, and an ongoing move by investors toward "the safest" paper, which means government bonds.

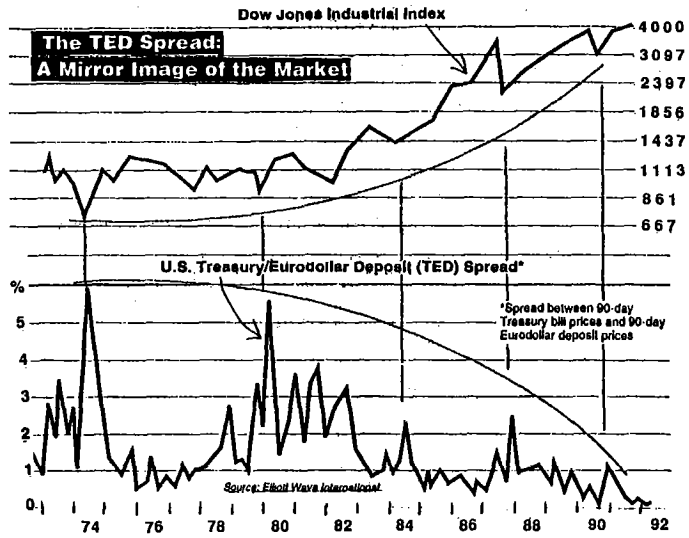
Bond funds you might look at are Benham European Government Bond Fund -- (800) 321-8321 and T. Rowe Price International Bond Fund -- (800) 638-5660. I particularly like the Benham Fund.

Note: The Japanese Nikkei Index on June 22 broke to another five-and-a-half year low (down a whopping 61% from its 1989 high of 39,916). I know most economists think that has little or nothing to do with our market, but I think the Nikkei action is ominous. As I've said so many times, primary trends tend to be international in scope, and the primary trend in Japan is clearly bearish. In time, I have to think we will receive a primary bear signal here. For that reason, I again advise "jumping the gun," which means that my subscribers should be very low or out of most equities.

Again, I'll repeat -- a global bear market would put terrific pressure on the world's central banks to bring interest rates down. This would be bullish for the safest category of bonds. The safest category of bonds are those issued by the advanced or developed countries.

**TED:** I've written about the TED spread before, but things are getting interesting now. The TED spread is simply the yield differential between the T-bill and Eurodollar deposits. The T-bill has the full faith and credit of the US government behind it, while the Eurodollar deposits (short-term borrowing by major European banks) are somewhat riskier because they are not backed by a government guarantee.

The TED spread is an excellent barometer of fear or complacency. Note that the spread surged as the stock market sunk in each of the big market sell-offs since the '70s. It's interesting to see that each spike peak in the TED corresponded roughly with a low in the stock market. Note also that each surge in the TED was smaller than the last. This is another way of saying that each market slide since the '70s was accompanied by less and less fear on the part of investors.

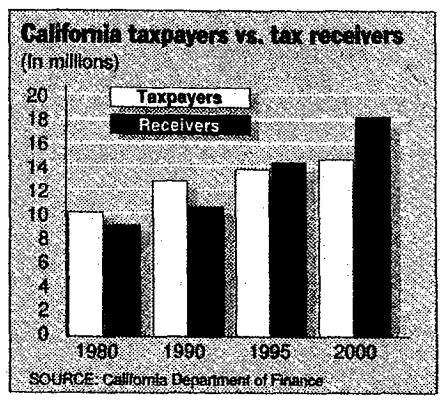



The fascinating part of the picture is that the TED spread is now roughly at a record low. What this seems to be telling us is that investors are extremely complacent regarding the economic picture. In fact, with a record low TED you might even say that investors are in a state of euphoria.

The TED has been so low recently that some of its followers are wondering if it still works. I think it does, but we have to ask ourselves what would produce the next spike in the TED? My guess -- intimations of world recession or depression, or a situation so serious (probably deflationary) that it casts doubts on the solvency of major overseas banks.

An ominous thought: Is it possible that in the eyes of investors the credit of major international banks is now almost as good as, or maybe better than, the credit of the US government? This, of course, is the one item that could invalidate the TED spread. That may sound outlandish, but the persistent long-term decline in the dollar may be raising doubts about the creditworthiness of the US government.

**NOTES & QUOTES:** I hate to keep talking about the Golden State, but California is supposed to be the bellwether state, right?



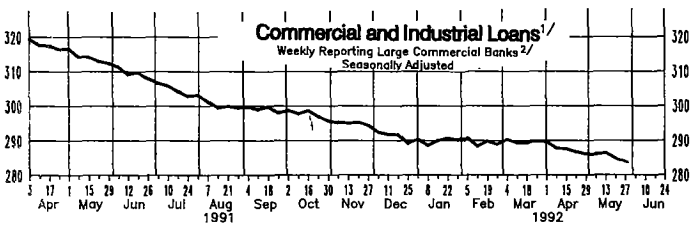

One out of every eight Americans live here, so the state is important. For that reason, you might study this shocking chart, showing that Californians on the "take" now actually outnumber the taxpayers. Is this the future of American society? With deficits projected at $11 billion this year (and this is after raising our taxes), Californians are facing huge new cuts in services and entitlements. By the way, of the thousands of people who poured into San Diego County over the past year, only 2% were from other states, while 98% of them came from outside the country. I mean it's getting very, very crazy here in the land of sun and palm trees.

* *

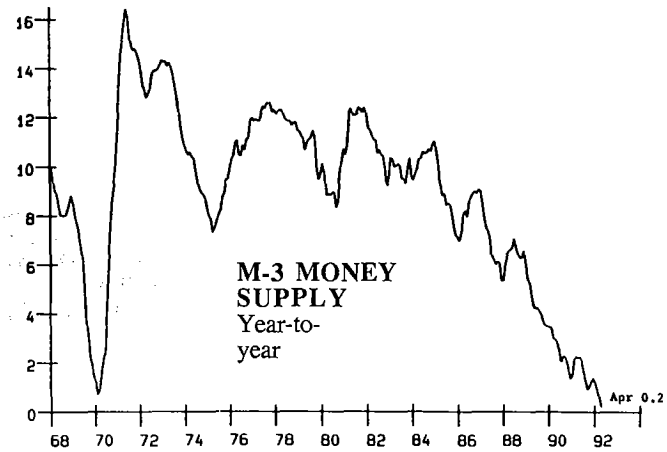
Ah, the troubles of the cities. NYC is fighting to retain four United Nations agencies, all of which are threatening to walk. The four agencies pump more than $200 million a year into the city. Three of the agencies are considering a rent-free proposal from Bonn, Germany. The other (the Children's Emergency Fund) is considering an offer from New Rochelle, NY, an offer which would reduce the agency's annual rent from $10 million to $531 thousand.

* *

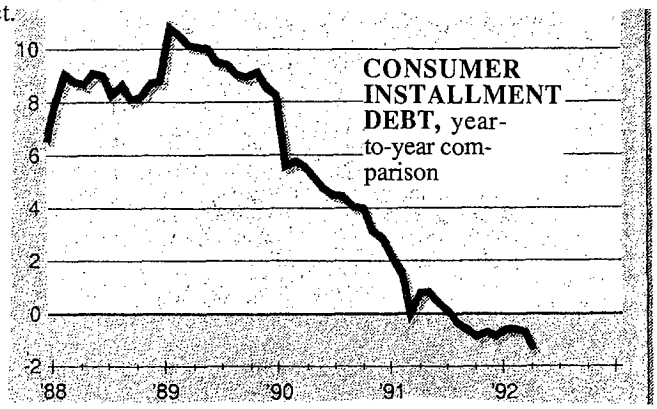
The US government and 10,000 economists are telling us that "the recession is over," but you'd never know it from these charts. The first (from the St. Louis Fed) shows Commercial and Industrial loans at a new low and dropping at a compound annual rate of around 7%.




The second chart (courtesy of Ed Hyman and *ISI)* shows the broad M-3 money supply at a zero rate of increase on a year-to-year comparison. The broader the measure of money supply, the more closely it relates to the economy.




The third chart (courtesy *Investor's Business Daily*) shows consumers cutting way back on their installment debt. Remember, consumer buying constitutes roughly two-thirds of Gross Domestic Product.




Can a recession end with the broad money supply standing still, loans at the banks declining and consumers cutting back? Gee, that's a good question.

* *

I don't usually double as a film critic, but if you're ready for a first class thriller, go see La Femme Nikita. I don't think I blinked once through the entire picture. If you can't find a theatre playing it, rent it on VCR. It's a French picture (dubbed in English), and it makes the current Lethal Weapon series look like childish nonsense. Whew!

* *

The rise of Ross Perot may be one factor in "spooking" the stock market. A recent poll showed that only 20% of CEOs of large companies favored Perot. Furthermore, Europe doesn't know what to make of Perot, and Japan is afraid of him. The "big money boys" figure this way -- they know what Bush would do if elected -- basically nothing. They know what Clinton would do -- tax and spend. But they have no idea what Perot would do, and that scares the hell out of them (note the constant attacks on Perot by newspapers and magazines).

* *

Readers know that I think the government's inflation figures are fudged. But this is interesting. Just after the Bretton Woods Agreement collapsed, inflation in the US rose to 3.5%. This was considered so dangerous at the time that Nixon slapped on wage and price controls. Times have changed. Now 3.5% is considered low inflation.

* *

Yesterday, a shoe lace on one of my sneakers broke. I bought another pair at a chain drug store, and the price was $1.29. Next morning I complained to Faye, "Damn it, when I was a kid I used to buy shoe laces from hawkers on the street corner at two packages for a nickel." Faye said, "Richard, you're sounding like an old man." "Hey," I snapped, "You really know how to hurt a guy. C'mon, I just can't relate to a buck twenty-nine for shoe laces. Just you wait 'til the Chinese start selling shoe laces." "Ho hum," said Faye, "Maybe you should start wearing hippie sandals."

* *

Greed. Many, many years ago I heard an adage which ran, "Don't marry a woman who has money, marry a woman who can make money." I could never make much out of that until the other day. Then it occurred to me that if you live in a community property state like California, that old adage takes on real meaning. If the woman has money she keeps that money, it's all hers. But if she makes money community property laws says half of it is yours. But wait -- let's not get sexist, the same reasoning applies to a man who makes money.

* *

The US defense program has become a massive "make work" program. Did you know that at the big military trade fairs the Pentagon pays the cost of taking various corporations' military hardware to these bazaars? What's happening is that US arms makers are frantic to replace sales to the Pentagon with sales to developing nations. The disgrace is that these nations already spend $200 billion a year on arms, and most of these same countries are too bankrupt to feed their own people. But the weapons boys say that selling arms is good for America, good for jobs. Sure it is, but it's a policy of moral bankruptcy. And President Bush is 100% behind it. Projected spending on Star Wars -- $28 billion! Gimme a break.

* *

Ex-fed hero Paul Volcker has written a book with co-author Toyoo Gyohten. The book is entitled, *"Changing Fortunes: the World's Money and the Threat to American Leadership."* The book discusses the fading out of the US as an invulnerable economic superpower, the Third World crisis and the end of Bretton Woods. I guess you could call it must reading for serious students. But there are some anecdotes. Here's one by Gyohten: "Recently I was talking to one of Japan's best foreign exchange dealers, and I asked him to name the factors he considers in buying and selling. He said, 'Many factors, some very short-term, and some medium and long-term.' I became very interested when he said the long-term, and I asked him what he meant by that time frame. He paused a few seconds and replied with genuine seriousness, "Probably ten minutes.' That's the way the market is moving these days."

* *

A seat on the NYSE just sold for $410,000, down from the last sale which occurred on April 16. The all-time high price for a seat was just over $1 million.

* *

As I see it, one of the biggest factors for change in this century has been communications and more specifically -- television. The new world of communication means that thousands of formerly city-bound people can now live almost anywhere they want. The new communications means that people in under-developed nations can see how people in developed nations live (and that instills the desire for free enterprise). And now AT&T announces a new tele-communication phone that will be available in the fall. Price will be around $1500, and you'll be able to use regular phone lines (probably at the normal price). Imagine what this should do for the dating business. There's only one negative in the new world of modern communications, and it's that kids aren't reading any

more. No, they just sit, glazed-eyed, in front of that modern baby sitter -- the TV set. By the way, it will be just a matter of time before the phone companies switch all their current copper- lines to fiber-optics. The total cost is estimated to be $100 billion (the new cables will be able to carry over 100 different TV pictures).

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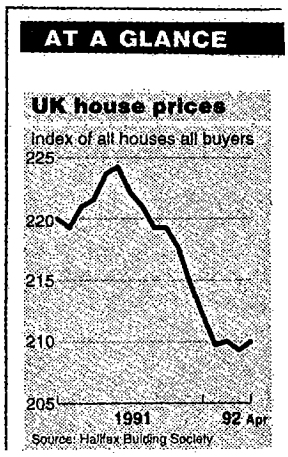
The recession in home prices seems to be worldwide. Here's a chart from London's *Financial Times* showing what's been happening to British home prices.

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In 1979 Ross Perot (he was head of EDS at the time) met with Bill Gates to discuss buying Microsoft. Gates' asking price was $40 to $60 million. Perot thought that was too high and turned it down. This year Microsoft at its peak hit a total value of $21 billion. According to an article in the *Seattle Times*, Perot still regrets his lost opportunity. Regrets, gosh, I'd be mad as hell.

* *

George Bush is becoming sort of a national embarrassment. I've been reading his lips, and I think I detect a quiver (maybe it's because it looks as though Saddam Hussein will remain in office longer than George). By the way, the National Intelligence Agency reports that Saddam is in a stronger position now than he was one year ago. The cartoonists aren't missing the picture, as witness this icy comment. As for the big Rio environmental conference, I note that not a word was spoken about that greatest of all global environmental menaces -- the human population explosion. I wonder where the pressure came from to avoid that critical item.

* *

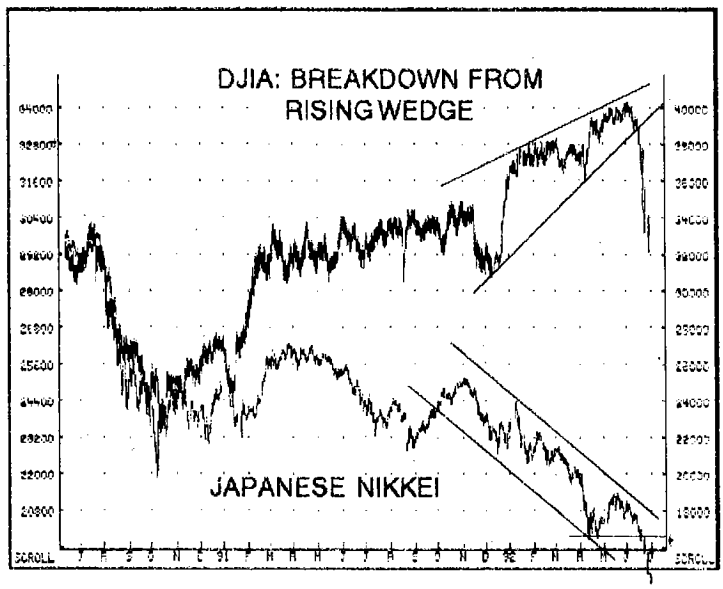
Speaking of pressure, the big food companies are finally coming out with a slew of low-fat and (better still) non-fat items -- everything from cakes to pasta to frozen yogurt. Buy them. The next thing is to lower salt. The whole country is hooked on high-salt items (they even put salt in ice cream). The "no salt items" are still hard to find. Do you ever look at the sodium (salt) content in most canned foods? It's horrendous. Avoid them. Most neglected item among higher-income families -- beans. Personally, I could live on pasta, beans (all varieties), fruits, vegetables and good bread. You can buy bread made without fats and with low salt -- these include bagels, bialis, french bread, sour dough, whole wheat pita and lavash (flat bread). Yeah, I (selfishly) want all my subscribers to live into their late-nineties (and a lot of you do).

* *

I keep my eyes on the big auctions, and from what I've seen art has been regaining a bit of its recent losses although buyers are much more selective. Prices of top grade jewelry and precious stones have held up well, and it seems that there are big buyers for quality pieces. I suspect that there have been buyers of gems as a store of value, and it is interesting that gem prices have held up much better than gold. Stamp prices remain in the doldrums while there has been some life in the rare coin market.

* *

Here's a chart from my friends at *M.J. Capital* (111 Great Neck Rd., Suite 502, Great Neck, NY 11021). This chart shows the dramatic divergence between the Dow and the Nikkei. The Nikkei is near a six-year low, while the Dow is still fighting to stay above its April '92 low of **3181.35.** As noted earlier, I consider 3181.35 to be a critical level.

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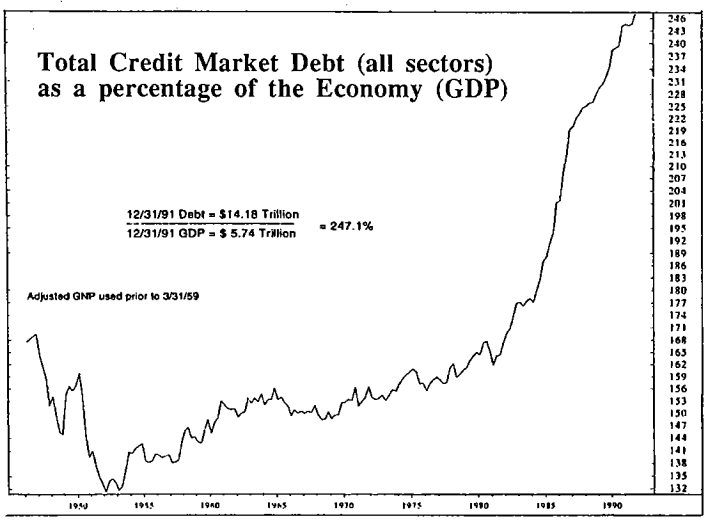
In reading Joe Granville's May 21 Letter, I note that he calls this "the weakest market I have ever seen with the Dow at a new high." I won't argue with Joe, although I do think the August 1987 market, with the Dow at a record 2722.42, looked even weaker (mainly because long Treasury yields at the time were at 10%).

Joe also points to a Ned Davis chart showing Total Credit Market Debt (all sectors) as a Percentage of the Economy (GDP). Joe likens the pattern of this chart to the famous parabolic rise in gold, the rise that led up to the 875 top in 1980. That top was followed by a 12-year bear market in gold. Joe notes that this kind of parabolic rise is "terminal and always produces the greatest downside moves." Then he sums it up by saying that on the basis of this chart pattern "we are now very close to a severe credit contraction." [Granville -- (800) 876-5388].

Parabola analysis is based on the thesis that "no tree, or in this case, no curve -- can grow to the sky." At least they don't grow to the sky where economics is concerned. And there's no question but that debt is now at an extreme as a percentage of Gross Domestic Product. No one knows at what point the total debt will topple the economy. But many years ago Hamilton Bolton (he founded the *Bank Credit Analyst*) noted that year after year it was taking more and more credit to produce less and less in terms of GNP.

You can see the situation clearly on this chart (courtesy of *Ned Davis Research*). Here is debt as a percentage of GDP climbing in a wild, parabolic curve -- and yet the Gross National Product of the US is rising at a feeble 2% rate. What would happen if debt creation topped out, started to tumble? Of course, this is exactly what the Fed is trying to forestall when it forces short-term rates down. But if credit creation collapsed, the nation would sink into depression as business ground to a virtual halt. Let me put it this way -- the US is subsisting on debts and deficits. Reverse the wheels, start a major trend of credit contraction (with the money supply dropping and money velocity sliding) and you'll have a bear market in stocks and the economy that will be as vicious as anything we've ever seen.

So the potential danger is pictured on this chart. But the great danger is that we've never seen the debt/GDP ratio fall apart from this high a level. Let's hope it doesn't happen. But remember -- in economics no tree grows to the sky. The ratio on the Davis chart is sky-high now. How much higher can we expect it to go?


Total Credit Market Debt (all sectors)
as a percentage of the Economy (GDP)
12/31/91 Debt = $14.18 Trillion
12/31/91 GDP = $ 5.74 Trillion
= 247.1%
Adjusted GNP used prior to 3/31/59

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A few weeks ago Zhu Senlin made an unprecedented four-day visit to Hong Kong. Zhu is the governor of the booming Chinese province of Guangdong. The visit heartened all of Hong Kong, and the Hang Seng Index pushed to new high after new high. The economies of Guangdong and Hong Kong have grown together so quickly that many economists are now referring to the two areas as a single economic entity.

After opening China's first stock market, Shanghai will now be opening the country's first futures exchange. Meanwhile, last week the authorities lifted all restrictions on stock-price fluctuations, and prices surged, the index almost doubling within a week! Of course the exchange now lists only 12 shares including one B class share for foreigners. Future trading, however, is a major step in China's economic reform program.

Then last week Jiang Zemin, leader of the Communist party, extolled the virtues of capitalism. In a striking speech to graduates, Jiang said that the main goal of China's economic reforms was to learn from capitalist nations. Western diplomats said that it was clear that Jiang had thrown in his lot with senior leader Deng Xiaoping's reform drive towards free enterprise. Russell comment: The die is cast. China is moving into the 1990s and the direction is capitalism.

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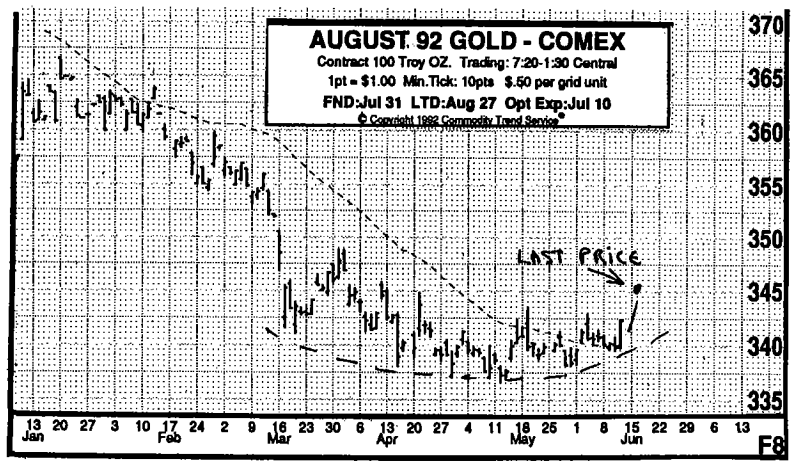
This from Ed Rollins, who ran Ronald Reagan's 1984 campaign (now co-chairman of the Perot campaign): "Breaking with the Republican presidential nominee was the hardest decision I ever made . . . I firmly believe that America today is at a crossroads. Traditional party allegiances are in flux. Our government is divided. There is a yawning chasm between the Democrats' hold on Congress and the Republican lock on the White House. Neither party can muster sufficient strength to overcome the other. But divided government itself is not the underlying problem; indeed, what this country really faces is a lack of leadership. And only the most die-hard partisans can fail to see the unprecedented grass-roots movement in support of Ross Perot as conclusive proof that the public's patience has finally been broken . . . After long and painful deliberation, I do not believe that George Bush and his advisors, who have been at the reins of power and policy for 12 years -- can be effective catalysts for change. Ross Perot can."

**GOLD:** Someone likes gold. Taiwan, with the world's largest reserves, has boosted its gold imports by 67% over last year (first five months). Taiwan bought roughly one billion dollars worth of gold between January and May. Taiwan, once the world's biggest gold buyer, is loading up again. In recent months the Taiwanese dollar also climbed to record highs against the US dollar. Taiwan's former "reason" for buying gold was to reduce Taiwan's huge trade surplus with the US. The current reason for buying gold is simply that Taiwan thinks gold is cheap, and many Taiwanese are trading in their stock shares for gold (from *Reuters*).

Gold jewelry has been selling in record amounts, and gold for jewelry now actually outpaces gold production (maybe the public knows that gold below 350 is intrinsically cheap). Many S. African gold mines are now being squeezed and some have closed, and I've heard that Russian gold production could drop 30% to 50% this year. With it all, however, the major moves in gold are based on consumers' perceptions regarding forthcoming inflation, rather than on supply/demand equations.

I continue to wonder (based on market action in Japan and the US) whether the primary trend of the world's markets and economies is now in the process of turning bearish? If so, you can be sure that the central banks will fight the trend. How? With inflation. The Fed has been doing that for months. In the US, adjusted bank reserves, the raw stockpile of money that is controlled by the Fed, has been growing at the explosive rate of 21% this year. If consumers and business ever become optimistic, this would allow for a massive rate of borrowing.

Does gold know something? The gold market is beginning to stir. Gold has rallied above, and remained above, its 40-day moving average, something it hasn't done all year (see daily chart). Gold momentum has turned bullish for the first time since last February. The gold stocks have been strong, and the XAU index (the gold/silver index) has pushed above 80 for the first time in 1992.




You want leverage, mull this over. I just bought the December 380 gold call options. I bought one batch for $1 and a second batch for $1.30. Because there has been so little interest in gold, the options are currently "cheap" (low implied volatility). I bought 25 options (the Dec. options expire on Nov. 13) for roughly $3,000. These 25 options give me the right to buy 2500 ounces of gold at 380 at any time up to Nov. 13. That's a call on roughly $950,000 worth of gold for $3,000. If, for the sake of argument, gold can climb to 400 by early November ($20 over the option price), these options would be worth a minimum of $50,000. If gold, for some wild and crazy reason, were to go to 500 by early November the options would be worth $300,000. Because gold options are currently cheap, the potential leverage is huge. And the total risk is the initial $3,000. Of course, you realize that this is a rank speculation (I'm fighting both time and price). But what the heck, it's a contrary opinion (nobody thinks gold is going anywhere), and it's cheap thrills. Columbus took a chance, why shouldn't I?

**LATE NOTES:** According to the latest *Barron's*, the combined earnings for the Dow has dropped to $48.13, an incredible drop from the year-ago earnings of $150.68. This has taken the P/E for the Dow to a new high of 68.3. With total Dow dividends of $103.11, this means that the Dow payout is more than double earnings. Result -- watch for either an earnings explosion or dividend cuts.

The losses in Japan are moving into the disaster area. And it's finally rubbing off on the world and US markets. I repeat -- I feel we are slowly but relentlessly moving into a global bear market. If so, it will not be good for the dollar.

**NEXT MAILING: July 8, 1992**